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Supreme Court, U.S.
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In The
Supreme Court of the United States

H.C. BAILEY, JR., W.C. BAILEY, JOAN B. BAILEY, HARPERVILLE IRREVOCABLE TRUST, JOHN T. COSSAR, GLYNN HUGHES, LEWIS S. TILGHMAN, KENNETH W. WARREN and MADISON HILLS FARMS, INC.,

Petitioners,

v.

UNITED STATES OF AMERICA and the FEDERAL DEPOSIT INSURANCE CORPORATION,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Federal Circuit

REPLY BRIEF FOR THE PETITIONERS

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The Government cannot disagree with the central proposition at the core of the petition, and therefore it cannot and does not defend the decision below on its own terms. Instead, it is forced to invent a new justification for that decision, one which it has never argued before and which is demonstrably false.

The petition advances a simple proposition: where the owner of a seized thrift can prove that, but for the Government's breach of a *Winstar*-type contract, the thrift would have survived and had positive value of no less than $X, the thrift owner must be entitled to recover $X. The Federal Circuit's decision rejects that simple proposition *as a matter of law*; yet, the Government's opposition to the petition does not even dispute it. Instead, it argues that summary judgment was properly entered against Petitioners because Petitioners failed to present "affirmative evidence" to support the claim that their thrift, Security Savings & Loan Association ("Security"), would not have failed but for the breach. That argument was never made to the court of appeals, was never advanced as a ground for summary judgment to the Court of Federal Claims ("CFC"), is entirely at odds with both the Federal Circuit's and the CFC's rulings, and, to boot, is totally false.

The Government's unwillingness to dispute Petitioners' core proposition is understandable. For the proposition is nothing more than the application of straightforward, black letter contract law: a defendant is liable for the foreseeable damages proximately caused by its contract breach. Here, the Government does not and cannot deny that it plainly foresaw that the breach of its regulatory capital promise would very likely cause Security (along with dozens of other thrifts) to fall out of capital compliance and to be placed in receivership, which in turn would surely lead to the creation of a receivership deficit. Thus, to defend the Federal Circuit's decision on its own terms would require the Government to explain why ordinary contract law does not apply in this context. This it cannot do. Eight years ago, this Court held that ordinary contract principles *must* apply in precisely this context. *United States v. Winstar*, 518 U.S. 839 (1996). If the holding of

Winstar means anything at all, it must surely mean that where the facts show that a plaintiff's thrift was seized by the Government solely because of the Government's breach of its *Winstar*-type contract, that owner must be entitled to recover something.

1. The Federal Circuit held that Petitioners "breach of contract damages must be capped at the alleged 1994 figure of $64 million." Pet. App. 6a. That $64 million reflected what the Petitioners' expert opined that the thrift seized by the regulators in 1992 would have been worth in 1994 had the Government honored its regulatory capital contract. Pet. App. 37a-38a. Alternatively, Petitioners sought as a more conservative measure of damages the value of their thrift prior to the seizure – $44 million – again on the express factual assertion that Security would not have failed but for the breach.

The Federal Circuit did not reject Petitioners' factual claim that Security would have survived but for the breach, and would have been worth between $44 million and $64 million. Instead, it ruled that "[n]either Bailey nor any other private creditor could benefit if the FDIC fully recovered its alleged contract damage claims because the maximum potential award of $64 million is exceeded by the FRF's subrogated claim of $66 million." Pet. App. 6a. Likewise, it concluded that Petitioners also could not recover damages of $44 million "because it also is exceeded by the $66 million." *Id.* The $66 million "subrogated claim," of course, represents the cost to the Government of a receivership that was caused by the Government's own breach of contract to the seized thrift. The Government's subrogated claim thus is a liability of the thrift in receivership, reflecting the losses incurred during the fire sale of the bank's assets, plus interest charges and other expenses that, according to Petitioners' never-rejected factual assertions, would not have been incurred but for the breach. Thus, the summary dismissal of Petitioners' case was affirmed because the positive value that their thrift would have had but for the breach ($64 million) was less than the negative value it had because of the breach ($66 million).

Let there be no mistake as to the extreme nature of this legal conclusion: if it is correct, then the Government could have *stipulated* below that Security would have survived but for the breach and would have been worth $64 million, and still the Federal Circuit would have held that neither Security nor its owners are entitled to recover anything. The Acting Solicitor General does not and cannot defend that rule of law. It is, quite simply, indefensible: as explained in the petition, it mangles Article III's "Case or Controversy" requirement, and works an appalling injustice on all thrift owners whose institutions were seized by the Government as a direct result of the Government's breaching its *Winstar* contracts, thereby undermining the *Winstar* decision itself.

2. Unable to defend that rule, the Acting Solicitor General tries to hide it. First, the Government tries to portray the case as a simple application of the statutory priority scheme that applies to thrift receiverships, under which governmental creditors must be paid first. Thus, it nonchalantly states that Petitioners' claims were rejected as nonjusticiable simply "because the government was a creditor of the receivership estate in an amount greater than any amount the estate could hope to recover from the government." Opp. 12-13.

But the obvious answer to this explanation is that the Government's claims against the estate were themselves *caused* by the Government's breach of contract: that is, but for that breach, Security would not have failed, and there would have been no "subrogated claim," no fire sale of the thrift's assets, no interest charges, no administrative expenses, and hence *no receivership deficit*. Thus, because the receivership itself was caused by the breach, it is simply not correct to state that the receivership deficit "was not 'an asset available for recovery.'" Opp. 15 (quoting Federal Circuit's opinion, at Pet. App. 5a). Rather, if it

was caused by the breach, that deficit must be recoverable as part of any expectancy damage award.[1]

That central proposition is the crux of Petitioners' entire case, and the Acting Solicitor General does not contest it. Nowhere in its opposition does the Government argue that the result below can be defended if the facts demonstrate – as they do – that Security would not have failed but for the breach.

3. Instead of contesting the central legal proposition of the petition, the Government attacks its key factual predicate, stating that "[t]he court of appeals never accepted as true that Security would have had a positive net worth of $44 million but for the breach, and in the current posture of this case, that fact cannot be assumed." Opp. 13. It goes on to assert that "Petitioners presented no evidence that [its] loss (the 'receivership deficit'), which was paid by the government, was caused by the government's breach." Opp. 14.

This is the heart of the Government's opposition. Only by arguing that "Petitioners presented no evidence that that loss (the 'receivership deficit') . . . was caused by the government's breach," is the Government able to resist Petitioners' proposition that the receivership deficit must be recoverable if the receivership itself was caused by the

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[1] To be sure, it does not matter to the private creditors and shareholders of Security whether the governmental liabilities in the receivership deficit are actually awarded as expectancy damages against the Government, since they represent amounts that would then be paid back to the Government under the priority scheme. What matters is simply that these losses, which the Government inflicted on itself as a result of its contract breach, not be allowed to offset the losses inflicted by the breach upon private shareholders whose thrift would have survived and been valuable were it not for the Government's breach. Thus, regardless of what Article III may require with respect to "awarding" *to the Government* its receivership deficit as an item of damages *against the Government*, it must not be allowed to obscure the basic proposition that private thrift owners must be entitled to some compensation if the facts demonstrate that they have lost a valuable thrift solely because of the Government's breach of contract.

breach. Yet it is precisely by advancing this assertion that the Government confirms that *certiorari* must be granted.

First, the Federal Circuit held that Petitioners must be dismissed *as a matter of law*, "even if" they can prove that Security would have survived and prospered but for the breach. The opposition itself admits this, as it describes the court of appeals decision as holding that, "because 'the maximum potential award of $64 million is exceeded by the FRF's subrogated [and legally prior] claim of $66 million,' '[n]either Bailey nor any other private creditor could benefit' *even if it were established that Security were entitled to that maximum award.*" Opp. at 11 (emphasis added) (citation omitted) (alterations in original). But Security would be entitled to an award of its but-for value only if the court concluded that the breach caused it to fail, and therefore caused the receivership deficit. Petitioners advanced an *expectancy* theory of damages – i.e., they sought to recover the profits their bank would have earned but for the breach. That entire theory is obviously predicated on the baseline factual assertion – supported by an expert report and other evidence – that the bank would not have failed but for the breach. Thus, the Federal Circuit (like the trial court) did indeed "assume" that the bank would have survived – and prospered – but for the breach. At a minimum, both courts made clear that the existence of such a fact would in no way have changed their decision to summarily dismiss Petitioners' case.

The Government cannot defend that legal conclusion, and therefore it invents a new one – Petitioners' alleged failure to "'present affirmative evidence.'" Opp. 13 (citation omitted). But it is crystal clear that neither the CFC nor the Federal Circuit relied in any way upon an "absence of evidence" that Security would have survived if the Government had honored its regulatory capital contract. There is not the slightest hint of that rationale in either opinion. Thus, if this Court refuses to grant *certiorari* based upon the "absence of evidence" argument, it will leave in place a legal holding that is so obviously wrong the Government refuses to defend it on its terms.

Not only is the newly-invented "absence of evidence" argument absent from the two decisions below, it also cannot be found anywhere in the lower court briefs submitted by the Government. The Government never claimed that it was entitled to summary judgment on the ground that Petitioners had failed to present "affirmative evidence" to create a genuine issue as to whether Security would have failed even absent the breach. Thus, the Government is defending the Federal Circuit's affirmance of the CFC's summary judgment by articulating a basis for dismissal that was never even surfaced before the trial court. This is especially egregious because Petitioners could have, and would have, offered in the trial court whatever evidence was necessary to create a genuine issue for trial on this key factual question.

Indeed, even though the Government did not raise this argument below, Petitioners more than amply satisfied any possible burden they conceivably could have had. Most importantly, Petitioners presented the trial court with an expert report in which the expert testified that as soon as FIRREA became effective, Security faced "an immediate capital compliance problem *as a direct consequence of the breach*" of the Government's regulatory capital promises. C.A. App. A30,008 (emphasis added). In addition, his report stated that "but for the breach," Security would have undertaken a business strategy that "would have allowed [Petitioners] to retain the value of their investment *and prevent the seizure and liquidation of Security Savings by the Government.*" *See* C.A. App. A30,010 (emphasis added). This expert marshaled all of the relevant financial reports and other evidence necessary to opine on Security's ability to survive but for the breach. His report was produced in association with Security's former Chief Financial Officer, who likewise demonstrated the thrift's ability to prosper absent the breach. Thus, Petitioners certainly presented sufficient evidence to withstand even the hypothetical summary judgment argument that the Government now acts as if it advanced.

Perhaps most powerful of all, however, is the evidence inherent on the face of the record: In the fall of 1990,

Security sought and received a district court injunction requiring the Government to honor its regulatory capital contracts. *Security Sav. & Loan Ass'n v. Director, OTS*, 761 F. Supp. 1277 (S.D. Miss. 1991). Even though Security was clearly out of capital compliance due to the breach, it was not seized during the pendency of this injunction. However, the Fifth Circuit subsequently reversed the injunction and transferred the case to the CFC, where Security once again immediately sought injunctive relief. *Security Sav. & Loan Ass'n v. Director, OTS*, 960 F.2d 1318 (5th Cir. 1992). Less than one week after the Federal Circuit affirmed the CFC's denial of injunctive relief, the Government seized the bank. Thus, as soon as the threat of injunctive relief was lifted, the Government knew that it was free to disregard its regulatory capital contract, and immediately placed Security into conservatorship. This history alone demonstrates that if the Government had been required to honor its regulatory capital contract, it would not have been able to seize Security.

In sum, there can be no doubt that Petitioners affirmatively presented ample evidence to the trial court to demonstrate that they would not have lost their thrift but for the Government's breach. The Government's synthetic basis for rationalizing the unjustifiable result reached by the courts below cannot stand.

4. The Government argues that Article III's "intragovernmental dispute doctrine" has "nothing to do with the court's rejection of Petitioners' claims." Opp. 12. It argues that Petitioners' damages claims "were rejected because they could not have resulted in any surplus to the receivership estate and, consequently, any net award to Petitioners." *Id.* But the only reason that Petitioners' damages claim "could not have resulted in any surplus" is that the receivership deficit, according to the courts below, could not be included in any damages claim. This meant that under the priority scheme the entirety of any damages award recovered by Petitioners would have to be paid over to the Government – the breaching party – to satisfy the receivership deficit.

Thus, whether the intra-governmental dispute doctrine was implicated depends upon the reason that the courts below held that the receivership deficit could not be included in the calculation of expectancy damages. As the petition recounts, the CFC offered two reasons: one was its view that the receivership deficit is an "obligation" rather than a "claim" on Security's balance sheet – wholly ignoring the fact that this "obligation" was directly caused by the Government's breach, and hence is as recoverable as any other liability or loss caused by the breaching party to the non-breaching party; the other reason was the CFC's conclusion that "'the receivership deficit claim is a non-justiciable intra-governmental controversy.'" Pet. 8-9 (quoting Pet. App. 39a-40a). Thus, the CFC's decision was clearly founded, at least alternatively, on Article III's "intra-governmental" dispute doctrine.

The Federal Circuit offered only a one sentence explanation for affirming the CFC's holding that the receivership deficit could not be included in the thrift's damage claim: "The claim for the recovery of the receivership deficit is predominantly held by the FRF because the largest portion of it is that which was absorbed by the RTC when it paid Security Federal's deposit liabilities." Pet. App. 5a. While the petition explains why this sentence is best understood as endorsing the CFC's intra-governmental dispute doctrine holding, *see* Pet. 11 n.4, it simply does not matter what this opaque sentence means. All that matters is that the Federal Circuit held that the Government is not answerable in damages for its breach of a *Winstar*-type contract where that breach directly, proximately, and foreseeably caused the bank to be placed into receivership, and where the receivership generated losses to the Government that were greater than the losses caused by the breach to the private owners of the thrift – i.e., the positive value of the thrift that was destroyed.

As the CFC's decision illustrates, there are in fact two different ways to describe that holding. At best, it is a grotesque distortion of what Article III requires, interposing the intra-governmental dispute doctrine as an obstacle to the ability of private plaintiffs to recover damages that they have personally suffered. At worst, it is an abrogation

of ordinary contract law – specifically, of the basic notion that foreseeable consequential losses caused by the breach (here, the receivership deficit) are recoverable – that is so flagrant, and so obviously wrong, that it can only be understood as an open defiance of this Court's holding in *Winstar* that these cases must be governed by "ordinary principles of contract construction and breach that would be applicable to any contract action between private parties." *Winstar*, 518 U.S. at 871. Unless *certiorari* is granted in this case, the Federal Circuit's decision threatens to convert that holding into nothing more than a cruel hoax.

5. The Government denies that the Federal Circuit's decision means that the Government's seizure of a thrift "'may not, under any circumstances, constitute a taking of property under the Fifth Amendment.'" Opp. 18 (quoting Pet. 20). According to the Government, the Federal Circuit merely held that "[t]he question whether a taking occurs depends on 'the cause of the insolvency.'" Opp. 18 (quoting Pet. App. 8a). But here, Petitioners alleged – and submitted evidence to demonstrate – that "the cause of the insolvency" was nothing other than the Government's breach of contract. Neither the Government nor the Federal Circuit even attempt to explain why that "cause" is "not sufficient" to constitute a taking. If the Government's direct abrogation of its own, bargained-for contract is not sufficient "cause," then what is?

As explained in the petition, this Court has held that Government assurances that are far less formal or bilateral than a contractual promise have given rise to expectations that provide a property owner with a right to Just Compensation under the Takings Clause. *Kaiser Aetna v. United States*, 444 U.S. 164 (1979); *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986 (1984). The Government's only answer to those cases is to point out that "neither case involved a contract." Opp. 20. That, of course, is the whole point: if the assurances in those cases gave rise to a right to Just Compensation, surely a contractual promise does as well.

It is also no answer to these authorities for the Government to argue that "the right of a non-breaching party

to a contract with the government to seek contract damages for the government's breach of contract forecloses a claim that the government's breach constituted a taking." Opp. 19. Here, the non-breaching party's contract remedy was *itself* foreclosed due to the Federal Circuit's conclusion that Security was not entitled to recover any damages "even if" it could prove that it would not have been seized and would have been worth at least $44 million but for the breach. Of course, if the arguments advanced above are correct, that conclusion should be reversed as a matter of ordinary contract law. However, to the extent there is some strange feature of either Article III or federal receivership law that somehow demands the Federal Circuit's rejection of Petitioners' contract claim, the Takings Clause must be implicated. It is simply not tenable that the owner of a thrift worth at least $44 million is entitled to *nothing* despite the fact that but for the Government's breach of its regulatory capital contract, the thrift would still be in business today.

CONCLUSION

For the forgoing reasons, the petition should be granted.

May 10, 2004

Respectfully submitted,

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